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Consumption potential in China's lower-tier cities

Looking beyond the prosperous metropolises

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Introduction

It was a bruising 2022 for China, the world's second largest economy. China's unbending approach to the pandemic until the fourth quarter of 2022 hobbled businesses and stifled growth. The crisis seeping through China's real estate sector—sparked by Chinese developer Evergrande's debt problems more than a year ago—has only worsened. China's bouts of trade tensions with the US reminded us of the turbulent and fraught relationship between the two powers. Fortunately, in November 2022, the Chinese authorities attempted to shore up the flagging economy and restore some semblance of normalcy. The authorities accelerated re-opening measures, taking the market by surprise with their swift action. While these big ups and downs can be distracting, a look under the surface reveals growth potential in the form of changing consumer landscape and consumption upgrades in China—especially within the lower-tier cities.

Lower-tier cities at the forefront

There is no official list dividing China's cities into tiers. However, cities in mainland China are commonly classified into four unofficial tiers according to factors such as their GDP, population and political administration. First-tier cities consist of China's largest in terms of their economy, population and administrative significance; they include only a handful of cities such as Shanghai and Guangzhou. Second-tier cities feature provincial capitals. They are smaller than first-tier cities but still feature large metropolises (e.g., Wuhan). Third-tier cities are generally prefecture- or county-level capitals, while the fourth tier contains other prefecture- or county-level cities with smaller populations and only a fraction of the GDP of their first-tier peers. Why the focus on lower-tier cities instead of the prosperous metropolises? The lower-tier cities, numbering in their hundreds, house around 70% of China's 1.4 billion people, with more than 330 million inhabiting third-tier cities.[1] This means a majority of the Chinese population now resides in lower-tier cities, enabling the consumer sector to bloom in such often overlooked urban areas. The youth population (aged 18-30) in lower-tier cities is also more than triple that of first- and second-tier cities.

It is not just sheer numbers, however.

While wages in lower-tier cities trail those of first-tier cities like Guangzhou and Shanghai, wealth and disposable incomes are creeping up across the board. Such rising affluence benefits areas such as sportswear, consumer electronics and food and beverages. The youth segment also sees a higher proportion willing to spend as they wield considerable purchasing power. In lower-tier cities, 70% of the youth population spent more than 80% of their monthly income in 2019 while their first- and second-tier peers spent only 63%.[2]

[1] "China 360, Small Cities, Big Aspirations", UBS, October 2022.
[2] "Helens Initiation", Goldman Sachs, April 2022.

By 2030, China's private consumption is set to more than double to US dollar 12.7 trillion, and there are already other signs of how spending in lower-tier cities could propel overall consumption growth.[3] Lower-tier cities displayed more resilience while consumption in upper-tier cities was more impacted by pandemic-related lockdowns in 2022. Policies are also supportive; the government plans to boost infrastructure and improve connectivity which could drive consumption and prosperity in lower-tier cities. According to an ancient Chinese proverb, "if you want to prosper, first build roads". The government has identified infrastructure as a key way to improve connectivity and enhance cross-city economic and technology development. The state council plans to increase its high-speed rail network by 32% from 2020 levels to 50,000 kilometres by 2025. [4] To give some perspective, the expansion would exceed the cumulative length of high-speed rail networks in Japan, Spain, France, Germany and Finland.

Shifting consumer attitudes could also give the consumer sector's expansion in lower-tier cities a further nudge. Consumers are now more discerning and conduct in-depth research and thorough comparisons before deciding on what to buy. Besides being more selective in terms of spending, consumers are pivoting towards domestic brands. We will elaborate on the changing consumer mindset and delve into the mind of the Chinese consumer below.

Identifying the lower-tier city consumer

Youth from lower-tier cities, also known as 小镇青年 in Chinese, include those tired of the "966" work culture and have returned home from first- and second-tier cities in pursuit of a better quality of life.[5] These youths work an average of less than eight hours daily and have more free time for their families, social activities and online and offline entertainment.[6] In addition, their financial burdens are smaller, given the lower cost of housing in lower-tier cities. In 2021, the property price to household income ratio was about 18 times in first-tier cities, compared to 8 times in second-tier cities and 6 times in lower-tier cities.[7] Consumers in lower-tier cities are seen to be under less pressure from mortgage and living costs, preferring proper dining to fast food. In addition, they also tend to dine out more as a family unit, leading to larger basket sizes at restaurants compared to solo diners in upper tier cities.

Home advantage for Chinese brands

For years, it was not uncommon to hear Western and multinational companies touting their ambitious plans to dominate the Chinese market—seen as a land of promise as markets elsewhere matured. However, many foreign consumer brands, including US behemoths with vast resources, now face stiff competition to grow their market shares in categories ranging from cosmetics to food and beverages. Foreign brands are seemingly struggling to understand the needs of Chinese consumers as a one-stop shop solution no longer fits. Consumers in lower-tier cities have different needs from their first- and second-tier counterparts. In addition, attitudes towards foreign brands in China are changing as perceptions of homegrown brands improve.

Domestic brands are seen to better understand the sophistication of consumers and their needs, and they incorporate traditional Chinese style and heritage. Young consumers have recognised the country's growing strength in culture, instead of wanting items that simply ooze foreign exclusivity—which have been so popular in the past.

Furthermore, domestic brands are not skimping on the cost efficiency, quality or product design aspects so they can meet the evolving needs of Chinese customers. Of course, the Chinese media—often unabashedly voicing out product or service issues with foreign brands—and geopolitical tensions, especially with the US, might have lent a hand in injecting impetus into local products and shaped consumer preference.

Florasis or "Hua Xi Zi" (花西子) is an example of a company which has successfully leveraged this trend. "Hua" is the Chinese word for flower and "Xi Zi" is the name of one of the four legendary beauties of Chinese lore. According to legend, "Xi Zi", also known as "Xi Shi", was so beautiful that fish ceased swimming and sank, while birds fell from the sky upon seeing her, mesmerised by her presence. Florasis focuses on creating makeup suitable for Asian women by extracting flowers and herb essences. In addition, the company's makeup sets are carved with intricate Chinese designs, enhancing the traditional heritage projected by the product. To appeal further to consumers, the company also invites users as experience officers to co-produce products, creating brand loyalty. Research and development (R&D) is of focus as well, with the company announcing that they would invest renminbi 1 billion in R&D over the next five years.

Reference to any particular security is purely for illustrative purpose only and does not constitute a recommendation to buy, sell or hold any security or to be relied upon as financial advice in any way.

[3] Morgan Stanley Research, January 2021.
[4] *South China Morning Post*, January 2022.
[5] "996" work culture refers to employees working from 9 am to 9 pm, 6 days per week, i.e. 72 hours per week.
[6] "Helens Initiation", Goldman Sachs, April 2022.
[7] "China 360, Small Cities, Big Aspirations", UBS, October 2022.

Price-to-performance ratio and novelty as the watchwords

We are also acutely aware of another behavioural trend that is emerging (or possibly already underway) in China. Chinese consumers are increasingly filling their shopping carts with items that offer low price-to-performance ratios, rather than donning a logo as a status symbol (though who wouldn't love to get their hands on luxury goods). At first glance, the focus on price to performance appears to be on the cheapest products. But Chinese consumers take it further, concentrating on getting the best value for each dollar spent. The focus is not just on price but on quality as well, a reflection of the increase in sophistication of consumer preferences. This shift has only been accelerated by the global pandemic. Although hedonistic businessmen feature prominently in media portrayals of consumption, in reality, price-sensitive consumers in China appear to be drawn towards brands offering good value for money—just like everywhere else in the world. Average consumers are seen to be putting a little more thought into their purchases and are less impulsive, tending not to outspend their budgets. We cannot emphasise enough the focus on value for money and quality.

Further, young consumers are increasingly leaning towards innovative products. They are looking for unique brands, and not always the ones at the top of the exclusivity list. Generation Z consumers, in particular, seem more eager to experience new products and services, not least because of the explosion of the Internet, social media and e-commerce platforms. Generation Z consumers are associated with a strong sense of self-identity and an inclination to express themselves by purchasing "novelty" items that allow for customisation and tailored services.

Saturnbird Coffee (三顿半) is a local brand that has captured the hearts of young consumers via its unique offering. The company identified a major instant coffee pain point: the need stir the prepared beverage with a spoon, a communal item in many office settings disliked by consumers. In 2018, the company came up with its premium super instant coffee using "Super Extraction™" technology, which retains the taste of freshly ground coffee and dissolves easily without the use of a spoon. Coupled with bright colours and eye-catching packaging, the company overtook Nestle in the instant coffee category during Tmall's Single's Day sales in 2019 and has not looked back since.

Conclusion

While consumer sentiment may be weaker across the country presently, we believe that the long-term outlook for China's consumer sector remains attractive. China's lower-tier cities are stepping up to fuel the growth engine that once relied heavily on megacities. We believe that the thirst for upgraded consumption and a confluence of socioeconomic developments—such as rising affluence, demographic trends and improved product-penetration rates—are facilitating the ascent of China's lower-tier cities.

We should also note the shifting consumer mindsets. Gone were the days when foreign brands were synonymous with quality and status while national brands were perceived less favourably. Chinese consumers are also more selective in terms of spending and price-to-performance ratio has become a key consideration.

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